



Can and should the EU and Russia reset their relationship?

By Katinka Barysch

★ Some observers in Europe think that Russia's current economic woes and President Medvedev's critical assessment of his country's situation will make Russia more humble and appreciative of EU offers of co-operation. EU officials are talking about a possible 'modernisation partnership' between the EU and Russia.

★ Any strategy that is predicated on positive change within today's Russia carries a big risk of failure. Vested interests and weak democratic institutions have left the Putin regime inflexible. The EU needs to be prepared to deal with a Russia that is often stubborn and defensive. EU politicians should stop talking about a strategic partnership and cut the number of EU-Russia summits. A new bilateral agreement may have to wait.

★ Meanwhile, energy and climate change offer scope for positive co-operation between the EU and Russia. But the EU needs to be prepared for continuing tensions over the common neighbourhood and international issues, such as the Iran nuclear programme.

José Manuel Barroso described the last EU-Russia summit in Stockholm in November 2009 as "one of the best meetings we have had". Nothing much was decided at the meeting. EU leaders and officials were simply glad that relations appeared back to 'normal' after the low-points reached in August 2008, when Russia went to war with Georgia, and in January 2009, when another Russia-Ukraine energy dispute left many people in the EU freezing and factories idle.

That 'normal', however, was already a state of paralysis, accompanied by disillusionment on both sides. Having once hoped for a strategic partnership, free trade, an energy union and constructive co-operation across the European continent, the EU today expects little of Russia. The Europeans are relieved that their internal divisions over Russia are shallower than they have been in recent years. Russia's more egregious behaviour has helped EU unity. Poland and Lithuania no longer block the EU's Russia policy in an attempt to draw attention to Russian bullying. Bilateral tensions between Russia and EU countries such as the UK and Sweden have subsided. The EU now is better able to speak with one voice to Moscow. But it is not clear what the message should be. Devoid of a coherent strategy, the most EU policy-makers seem to hope for is to avoid another crisis.

Stale and stagnant

"When was the last time we decided anything of substance [at an EU-Russia summit]," shrugs one EU official. Another lists the meagre achievements of the summit as signs that there is still life in EU-Russia relations: the EU and Russia agreed on an early warning mechanism designed to facilitate the management of future energy crises; they put some money into cross-border co-operation programmes; and Russia used its meeting with EU leaders to announce targets for cutting carbon emissions ahead of the Copenhagen climate change summit.

One the whole, however, the EU-Russia relationship is stagnating. Talks on a new partnership and co-operation agreement (PCA) are in their 7th round, without having produced much substantive agreement. That is no surprise, given that the EU wants a 'package deal' across all areas, and that there is no progress in the areas that matter most: trade and energy.

The Russian leadership is prevaricating on whether Russia should finally join the World Trade Organisation or first build a customs union with Belarus and Kazakhstan. Before Russia is ready for WTO membership, it makes little sense for the EU and

Russia to talk about a free trade zone. Meanwhile, bilateral EU-Russia trade talks focus on limiting the damage from Russia's occasional erratic tariff hikes. On energy, there is plenty to talk about (see below). But EU hopes that PCA clauses would be based on the principles of the Energy Charter Treaty (a multilateral framework for energy investment and trade) were set back in 2009, when Russia withdrew its signature from the treaty that it had hitherto refused to ratify.

Of the many technical committees established by the old PCA, only one (on customs) has met in the last five years. In its human rights dialogue with Russia, the EU has encountered "zero openness", in the words of one official involved. The project to integrate the EU and Russia across four 'common spaces' (in economics and energy; foreign and security policy; internal security and justice; and education and culture) has produced little more than anodyne reports. Although President Dmitry Medvedev recently admitted that some EU laws were of top quality, Russia remains allergic to the idea that it should unilaterally take over EU rules and regulations. For the EU, the idea of 'converging' towards Russian standards is equally unappealing. Hence integration efforts have gone nowhere.

Some leaders in the EU are tempted to devise yet another re-launch of EU-Russia relations. One EU diplomat said he was surprised that there had not been more "reset envy" in European capitals after the Obama administration declared that it wanted a new start in its relationship with Russia. The Zapatero government in Spain, which holds the EU presidency in the first half of 2010, has made a new accord with Russia a priority. Brussels insiders suspect that Russia-friendly politicians in Berlin, Rome and Paris are itching to come up with some big new initiative. But what?

The US 'reset' is about a new arms control agreement and getting Russian support for western policy in Iran, Afghanistan and other trouble spots. Questions of commerce, energy and arguably even Russia's neighbourhood are secondary. Washington can be hard-nosed, focused and strategic in its relationship with Moscow.

International issues are obviously an important part of the EU-Russia relationship as well, in particular Russia's unwillingness to back tougher sanctions on Iran. The EU, however, has a much more complex relationship with Russia, which makes strategic trade-offs a lot trickier.

Some in the EU are still hoping to find a mechanism that will create enough trust, interdependence and convergence with Russia to allow for mutually beneficial co-operation across all areas. In the corridors of Brussels, plans for a 'modernisation partnership' are once again being talked about. Germany's former foreign minister, Frank-Walter Steinmeier, used the term frequently in 2007-08 to offer German help for Russian reforms in healthcare,

science and public administration. Germany's industrialists, many of whom have sizeable stakes in the Russian economy, cheered the idea. France – never far behind when it comes to doing bilateral deals with Russia – launched its own modernisation partnership with Russia in November 2009. Since French business is less engaged in Russia, the agreement focused on energy deals and the sale of French warships to Russia – much to the chagrin of people in the Baltic states and other East Europeans wary of Russian intentions.

A modernisation partnership?

EU officials have been talking about a possible EU-Russia modernisation partnership since 2008. Although they have not gone into detail, the basic idea seems to be that the EU would assist Russia in its reform efforts by providing capital, technology and training. The underlying assumption is that a more 'modern' Russia would be more western-oriented, open and easier to deal with. Russia showed little interest in such overtures from the EU while it was still enjoying an oil-fuelled economic boom and foreign money was flowing in.

In 2008 Russia's economic luck turned. The country was hit harder by the global economic crisis of 2008-09 than most other large emerging market countries. It suffered not only from a domestic financial freeze and a drying up of much-needed foreign capital but also from the collapse in oil prices. In 2009, Russian GDP fell by 8 per cent while foreign direct investment nearly halved. A big budget surplus has turned into a gaping deficit. Sovereign reserve funds have dwindled. With oil prices seemingly stuck around \$70 a barrel (and gas and metals prices also depressed), replenishing these reserves will take time. Economists inside and outside Russia say that the country must take lower commodity prices as an opportunity to finally diversify the economy away from oil, gas and other basic commodities.

President Medvedev seems to concur. In 2009 he launched several volleys of stinging criticism about the state of his country: the over-dependence on oil and gas exports, the ubiquitous corruption, the stifling bureaucracy, the oligarchs making a quick buck without building sustainable businesses. The solution, Medvedev said, was modernisation, liberalisation, the rule of law and more personal freedom.

For some Europeans, the weak state of the Russian economy, together with the outbreak of self-flagellation at the top, represents an opportunity. In a survey published by the EU-Russia Centre in January 2010, 81 per cent of the Russian foreign policy experts and lawmakers polled said that Russia could not modernise without foreign help. As Russia's biggest trading partner and investor, the EU is, in theory, superbly suited to help Russia embark on the kind of economic revolution that Medvedev seems to have in mind.

It may therefore seem natural for the EU to re-brand its relationship with Russia once more: the objective of a ‘strategic partnership based on common values’ has alienated Russia rather than draw it closer to the EU. Why not replace it with a more pragmatic ‘modernisation partnership based on common interests’? The EU obviously has a big stake in the success of Russia’s modernisation efforts. But there are risks involved in the EU trying to re-launch its Russia policy based on a concept that is, upon closer inspection, problematic.

First, the transfer of more EU money, technology or know-how may help Russia to modernise but it may not result in any kind of partnership. Many Russians think that the financial and economic crisis has discredited the western model of capitalism and that Russia should look more towards China and other fast-growing emerging markets for an economic development model.

While links to the West remain obviously important, Fyodor Lukyanov, a Russian foreign policy analyst, argues that Russia’s foreign policy recently went through a “paradigm shift”. Ever since Mikhail Gorbachev, Russian foreign policy was underpinned by the idea that Russia was destined to join the European mainstream and integrate into western institutions. Vladimir Putin, during his presidency, sought to change the process by which this would happen – more mutual convergence, less unilateral adjustment by Russia – but the basic idea remained valid. Today neither Putin nor Medvedev talk about integration. Medvedev has admitted that Russia would benefit from western help with its modernisation efforts. But, says Lukyanov, Russians see the EU as a reservoir of money, skills and technology; not as a model on which Russia will ultimately converge. If the EU was serious about helping Russia to reform, the result could either be a Russia that is stronger, but not necessarily easier to deal with; or a Russia that has been destabilised by radical change that undermined the Putin regime.

Second, a genuine modernisation alliance would have to be bottom-up and driven by the private sector. The Russian leadership is pursuing a model of modernisation that is state-centric and top-down. It throws money at new institutes to foster research, it nationalises big industries, it tells state-owned banks which sectors to lend to. It does not do the things that would be required for genuine economic diversification: foster entrepreneurship and innovation, reduce corruption, invest in a modern education system, cut red tape, reign in monopolies, shake up the court system and liberalise finance. “Top down rarely works,” wrote Andrew Wood, a former ambassador to Moscow, in a recent paper, “particularly in a country with a vast, ill-organised and deeply corrupt machinery of government [...]. Even if the Archangel Gabriel was in charge, it would remain so.”

Bottom up does not work either, at least for now. EU companies have invested billions in the Russian economy. However, total foreign direct investment is far too low to have the kind of transformative impact it had on say, Hungary (Russia’s stock of FDI is 20 per cent of GDP, much of it in oil fields and supermarkets, not industry. Hungary’s FDI is 180 per cent of GDP, well-diversified). While Russia broadly welcomes foreign money and technology, the 2008 law on foreign investment puts tight restrictions on foreign ownership in 42 ‘strategic’ sectors.

Even in non-strategic sectors, foreign companies complain about burdensome rules and arbitrary state interference. Some fear the theft of their intellectual property. As long as Russia’s business environment remains difficult and unpredictable, there is little the EU can do to coax private companies to channel more money and technology eastwards.

Sending western executives and engineers to Russia is becoming harder, not easier, due to Moscow’s tough visa and work permit restrictions. European scientists are unlikely to flock to a country that cannot even hold on to its own researchers (who are emigrating in droves).

In short, unless Russia is really ready to reform, any modernisation partnership would be limited to a few government or EU-led co-operation programmes. Such programmes in say, science, industrial policy or the judiciary may be useful for the people and companies involved. But they would hardly be enough to help transform the Russian economy or give momentum to EU-Russia relations. If there was political will to drive such projects forward, the EU and Russia could do so easily in the framework of the PCA and the four common spaces.

The Brezhnevisation of Putin’s Russia

The idea of a modernisation partnership suffers from the same challenge as previous attempts to build a functioning relationship with Russia: its success is predicated on positive change within Russia. There is no doubt that Russia has changed tremendously since the 1990s, but not necessarily in the way that the EU and its capitals had wished for. And it is not clear that today’s Russian leadership can, or wants, to move towards more competition, the rule of law and more personal freedom. While President Medvedev highlights the need for open markets and entrepreneurial freedoms, Prime Minister Putin (who most experts assume really calls the shots) is now talking about “Russian conservatism” and the need for state control of the economy.

Many in the West may be encouraged by Medvedev’s frankness about his country’s weaknesses. But Russia’s liberals are downbeat: Putin used to sound pro-reformist too in his early years as president. And now Medvedev, the (notionally) most powerful

person in the country, is warning that Russia is going to the dogs unless radical change starts soon; yet still nothing happens. Vested interests are deeply entrenched. The economic crisis may have cost many oligarchs their fortunes but it pushed the share of the economy controlled by the state to over 50 per cent. Top officials close to Putin now govern many of the largest enterprises. The middle classes – who in many emerging economies are in the forefront of arguing for better property rights and more personal freedoms – are apathetic. Too many owe their relative comfort to state employment or handouts. Since Russia's democratic institutions function badly, the whole system is precariously balanced on the whims of Putin and his small circle.

The EU can and should remind the Russians that their economic model is unsustainable. It should call for improvements in the business environment that would benefit European and Russian companies alike. But just like the Soviet Union in the 1970s, the Putin regime might already be too rigid to allow for the big and broad changes necessary to guarantee economic diversification, modernisation and sustainable growth. Some analysts are now talking of the 'Brezhnevisation' of Putin's Russia.

A Russia that is inflexible and brittle will remain an awkward partner for the EU. If leaders consider internal change too risky, they may find it easier to blame others for Russia's predicament and block international initiatives to show their strength.

Threat to the energy super-power

While the prospects for an overall 'reset' of EU-Russia relations look meagre at the moment, there is scope for constructive co-operation in energy and climate change. Before the onset of the economic crisis, the EU bought about a quarter of its total gas needs from Russia (now it is somewhat less). For Russia, the EU remains by far the biggest and most lucrative market for its oil and gas, with 90 per cent of energy exports heading westwards.

Yet the energy relationship between the two has been beset by problems. The initial idea of the 'EU-Russia energy dialogue', launched in 2000, was that Russia would liberalise its oil and gas sector while the EU would help with money and expertise. When Putin became president, he quickly realised the strategic (and economic) value of controlling the world's biggest gas company and longest pipeline network. Instead of breaking up Gazprom, the state reacquired majority control and encouraged the gas giant to snap up refineries, pipelines and distribution rights across Europe. During the years when oil and gas prices rose steeply and continuously, Russia felt in a strong position to set the terms of its energy relationship with EU countries.

However, in 2008 oil prices collapsed, and gas prices followed with a lag. In 2009 European gas demand

fell for the first time ever. Although oil prices have recovered to some extent, the sluggish global recovery will cap energy demand. In addition, new technology allows the commercial exploitation of massive amounts of 'unconventional' gas (gas coming from rock formations) in the US, and probably soon in Asia and Europe too. Already, additional supplies have depressed prices in the 'spot' market for short-term gas contracts. European companies have tried to wriggle out of their more expensive long-term contracts for piped gas from Russia and Algeria.

The EU's climate change targets and its emerging diversification policies are adding to Gazprom's uncertain prospects. Some countries may need more gas, to wean themselves of dirtier coal or to complement more volatile energy sources such as wind. On the other hand, if the EU is to achieve its targets of increasing energy efficiency (by 20 per cent by 2020) and boosting the share of renewables to 20 per cent, the role of gas in the energy mix will have to shrink. The Europeans are also debating how to diversify their gas supplies away from Russia. Many in Europe ridicule the EU-backed Nabucco pipeline through Turkey and the Balkans as a pipedream. But Gazprom has taken it sufficiently seriously to push ahead with its €20 billion South Stream pipeline that – if it were ever built – would compete with Nabucco for both Caspian gas reserves and South East Europe's fast-growing energy markets.

Pipeline competition, disputes over long-term contracts and uncertainty over both supply and demand make for an antagonistic energy relationship that benefits neither the EU nor Russia.

Climate change and energy efficiency

Against the backdrop of heightened uncertainty in global gas markets, Russia may become a more forthcoming negotiating partner in energy. If the EU offers 'security of demand' (meaning that the big European energy companies stick to long-term contracts with some sort of predictable pricing formula), Russia may compromise in other areas. There is plenty to talk about. The EU may want to ask Russia why it wants to build the expensive and technically complex South Stream pipeline rather than, say, use Nabucco to transport Russian gas to South Eastern Europe. Russia will need western capital and know-how to develop difficult new gas fields. The EU still wants Russia to accept joint principles on energy sector investment and transit.

While negotiations over gas will probably remain tricky, the EU and Russia should increase the climate change component of their energy relations. Russia is the world's fourth biggest emitter of CO₂ (if the EU is taken as a bloc) but it has so far shown scant interest in joining the global fight against climate change. Russia's economy remains one of the most energy inefficient in the world (it takes three times as much energy to

produce a unit of GDP in Russia as in the EU). Russia is planning to use more coal, not less, for heating in the future. Just 1 per cent of Russia's energy output comes from renewables. Experts say this could rise to 30 per cent if the country started building dams, solar panels, wind turbines and geothermal power stations.

Some Russians may welcome the prospect of warmer weather. But the World Bank and other research outfits predict that Russia is, in fact, exceptionally vulnerable to the threats of climate change. Thawing permafrost could turn vast landscapes into unmanageable swamps (and release methane gas that is even more dangerous to the world's climate than CO₂). The many people who live in shoddy, Soviet-era housing would suffer a lot if floods and storms became more frequent.

Although Russia belatedly declared at the EU summit that it would aim to cut its CO₂ emissions by 10-15 per cent by 2020, from 1990 levels, that target is not terribly ambitious. Russia's carbon emissions fell steeply in the 1990s when much of its Soviet-era industry collapsed (which has allowed Russia to make huge profits from selling unused carbon credits under the Kyoto protocol). Emissions are now on the rise and Russia can allow them to increase and still meet its 2020 target. Existing government plans for energy savings and higher gas prices have been put on ice during the economic crisis. If Russia managed to make progress on energy efficiency, it would not only help the world's climate but also encourage its industries to become more competitive. It would also free up more gas for sale in more profitable markets abroad.

The EU and Russia agreed to work together on energy efficiency in 2006. But a joint task force on energy efficiency has met only a few times since then and a limited number of pilot projects will not have a big impact. Clearly there is ample room for co-operation in this area, as well as in setting up the mechanisms needed to curb carbon emissions. Russia does not have the means at the moment to monitor and restrict emissions from individual factories or power plants. The EU – which has much experience in these matters – can help Russia to build up the infrastructure and expertise so that one day the country will be able to join an emissions trading scheme.

The EU-Russia energy relationship would probably be more cordial if it was less exclusively focused on pipelines and mutual market access and more on co-operation on climate change and energy efficiency. The EU – which is struggling to reclaim its leadership on global climate change after being painfully sidelined in Copenhagen – should make it a priority to help Russia become greener. Such co-operation should in theory be free from the ideological battles that stymie other joint economic projects.

However, even if the EU and Russia manage to forge a smoother energy and climate change partnership, it is unlikely that this will create enough goodwill on both sides to prevent disagreements in other areas.

The most contentious issue will remain the fate of the countries that lie between the EU and Russia, in what the EU calls the common neighbourhood.

Tensions in the neighbourhood

Russia initially watched with unease as the EU took in ten Central and East European countries and sought to draw non-candidate countries closer through its 'European neighbourhood policy'. Moscow then relaxed as it realised that the ENP had little discernable impact, and that even EU membership did not prevent Russia from doing good business and building political links in countries such as Bulgaria or Slovakia.

Nevertheless, the EU's 'Eastern partnership' initiative, launched in May 2009, met with an angry frown in Moscow. The EaP foresees deeper integration and stronger co-operation with six countries in Eastern Europe and the Caucasus, beyond what is on offer to the EU's Mediterranean neighbours. It is not that the Kremlin has suddenly developed more respect for the EU's ability to act. The EaP suffers from some of the same flaws as the ENP in that it does not provide enough incentives to entice Ukraine, Moldova and the other partnership countries to change.

But the initiative was launched at a time when Russia's own neighbourhood policy was in deep trouble. In the aftermath of the Russia-Georgia war in August 2008, even Russia's staunchest allies sought to hedge their bets by diversifying their foreign policies. Armenia started talking to Turkey. Turkmenistan reinforced its energy ties with China and made encouraging noises about selling gas to the EU. Belarus – previously barred from joining EU programmes because of its shoddy human rights record – did just enough to be allowed to join the Eastern partnership. Not a single former Soviet country followed Moscow in recognising the independence of Abkhazia and South Ossetia.

Moreover, now that NATO accession for Georgia and Ukraine is no longer a near (or even medium) term prospect and the US has scrapped its missile defence plans for the Czech Republic and Poland, Russia's zero-sum thinking about the common neighbourhood seems to be increasingly focused on EU plans. The EaP could give the neighbours more options and thus make it harder for Russia to keep them in its "privileged sphere of interests", as Medvedev likes to call Russia's post-Soviet neighbours.

EU politicians and officials like to stress that the EaP is in the 'common interest' of the EU and Russia. They argue that Russia should want a stable, prosperous and secure neighbourhood just as much as the Europeans and the neighbours themselves. Alas, few Russians see it this way. Russian foreign policy-makers know that they would find it much harder to meddle in a region where 'frozen conflicts' have been resolved, governments are legitimate and economies are

growing fast. And a stable South Caucasus would be better territory for pipelines that circumvent Russia.

Therefore, the EU's idea to make the EaP more palatable to Moscow by inviting it to join region-wide co-operation projects has made little headway. That is Russia's loss. The EU needs to stand firm and be prepared for tensions over the common neighbourhood. It should reinforce the Eastern partnership and communicate to Russia in private that the sovereignty and independence of the countries in the neighbourhood are 'red lines' that Moscow must not cross. If it does, both the EU and its capitals should be prepared to scale back relations with Russia (and not only by suspending treaty talks like the EU did after the Russia-Georgia war).

The EU was right to react to Russian proposals for a 'new European security architecture' with caution. Some West European policy-makers have expressed sympathy with Russian complaints that it feels sidelined, even threatened, in an EU and NATO-dominated European space. But most Europeans read the proposals put forward by Medvedev and other Russian politicians as an attempt to drive a wedge between Europe and the US and to give Russia a *droit de regard* in its neighbourhood. For the EU member-states this is a non-starter.

Russia's main problem with the current European security structure is not the EU but an expanding NATO. Nevertheless, the EU could not entirely ignore Medvedev's overtures. EU officials have stressed that Russia's almost exclusive focus on hard security does not mesh with the EU's own thinking which stresses not only new threats such as cyber-crime and terrorism but also highlights the economic and human rights dimension of security. The EU also insists that the OSCE is the best venue to discuss such issues; and that although a binding treaty may well be one of the outcomes of an ongoing debate about security, it should not be the starting point.

A partnership of necessity

EU-Russia relations are back to 'business as usual' following the tensions over gas cut-offs and the Georgia war. The Russians have enough problems to deal with so they welcome smooth relations with the EU. The EU member-states are more united on Russia than they have been in years but that has partly to do with the fact that there are no big, contentious issues on the EU-Russia agenda. Business as usual between the EU and Russia has become a frustratingly slow process of moving towards economic integration, a functioning energy partnership and a better political understanding. Setbacks have been frequent. Some EU politicians may be tempted to re-launch or reset EU-Russia relation once again by giving it a flashy new name, such as a modernisation partnership. They

should resist. On the contrary, the EU should concede that its initial ambitions for its relationship with Russia have not materialised and that the slow pace of internal change in Russia limits what can be achieved in bilateral relations. The reality is that EU-Russia relations have more potential for improvement in some areas (energy, climate change) than in others (the common neighbourhood). There is no magic formula that can change that.

The EU should continue pursuing its PCA negotiations with Russia, but not at any price. The main ingredients for the new treaty are energy and trade. Only once Russia has joined the WTO does it make sense for the EU to offer deeper EU-Russia trade integration. The EU thinks that the carrot of better market access is needed to entice Russia to accept the more liberal principles on energy investment, trade and transit that the Europeans want to see in the new treaty. That may be so but even without the new PCA there is lots of room for improvements in EU-Russia energy relations.

EU-Russia relations are unlikely to take a big leap forward in the near future. The EU should acknowledge that fact and reduce the number of summits it holds with Russia from two to one a year. Having a summit every six months puts pressure on politicians and officials to come up with 'deliverables'. The EU-Russia relationship is already littered with plans, forums and dialogues that work badly or not at all. It does not need any new initiatives.

The EU should also tone down its rhetoric on strategic partnership and put more effort into transmitting a clear and consistent message to Russia. The message should be that the EU stands ready to move forward on deeper integration and more extensive co-operation with Russia. But it wants to see progress on economic reform as well as human rights and political freedoms.

The EU's strongest stance must be reserved to questions regarding the common neighbourhood. The EU cannot and will not accept any Russian claims to a sphere of influence. The countries in that region have the right to define their own destiny. While being firm on this point, the EU must, however, be careful not to adopt the kind of zero-sum approach that many Russian policy-makers display, for example by appearing to allow the likes Belarus and Ukraine to participate in EU programmes only if they pursue the 'right' stance towards Russia.

*Katinka Barysch is deputy director of the
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